

prices is typically achieved for small customers through overlapping multi-year contracts, while regulated service for large customers, if offered at all, is procured and priced on a much shorter-term basis;

- Procurement processes are pre-approved by regulatory commission, which facilitates the almost immediate approval of procurement results;

- With the exception of Maine and Texas, where standard offer suppliers become retail providers of the generation service, the standard offer approach is based on wholesale contracts between suppliers and the respective distribution companies.

All standard offer states bid out shares of their regulated service load separately for different customer classes. The degree of aggregation or disaggregation varies by state. Furthermore, different states have made different choices on how to tailor the service for each group. For example, New Jersey, Maryland, D.C., and Ohio provide greater price stability for small customers than larger industrial customers, with overlapping one- to three-year contracts for residential customers.

Massachusetts uses six-month procurement cycles with overlapping one-year contracts for residential customers, but this is in part driven by a state law that exempts contracts of up to one year from preapproval requirements. Annual or even shorter-term contracts are typically used to procure supplies

for regulated service options offered to large customers, who generally require less price stability and who will be more predisposed to opportunistic switching between regulated and competitive service options in response to temporary price differences. In this regard, Texas and New Jersey are the extreme examples, with large customers



being offered only hourly wholesale spot market pricing. Massachusetts has moved to quarterly procurement and pricing of regulated service options available to large customers.

The following bullet points summarize the design and status of standard offer approaches in several of the retail access states that already completed (or are about to complete) their rate-freeze periods.

- **Ohio.** Based on a recent order by the Ohio Public Utilities Commission (PUC), the standard offer approach has been selected as the default procurement methodology for Ohio utilities, as some of them may transition out of their rate-freeze period at the end

of 2005.⁵ Although alternative processes can be proposed by the utilities, this default methodology requires utilities to establish competitive procurement processes for load shares of full-requirements service for residential, small non-residential, and large non-residential customers. These customer classes will be offered fixed- and variable-priced rate options based on overlapping supply contracts of one to three years in duration. The Ohio PUC encouraged independently monitored auctions as the procurement process, though implementation details have been left to the individual utilities. The PUC noted improved risk allocation (by placing the risk on the winning bidder as reflected in bid prices) as a benefit of this approach.

So far, however, most Ohio utilities have submitted alternative processes under which the initial transition period essentially is extended for several years. Nevertheless, the state commission has continued to demonstrate its preference for the standard offer approach by requiring that First Energy conduct an auction.⁶

- **Maryland and the District of Columbia.** The Maryland Public Service Commission (PSC) and the PSC of the District of Columbia have implemented very similar approaches. The Maryland approach, based on two PSC-approved settlements with a large group of stakeholders, implemented a post-rate-freeze procurement model in which regulated service load (called "standard offer service")

is segmented into individual percentage shares of full-requirements service for residential and three groups of non-residential customers.⁷ (Each load share was sized to represent an annual peak load of approximately 50 MW, with contract durations from one to three years.) The PSC found that this standard offer model represents a sound public policy choice, offering high transparency and giving customers price stability while also promoting reliability. The PSC also recognized that the majority of jurisdictions that have enacted retail choice have adopted the standard offer model. Additionally, the PSC found that bidders are already familiar with this approach, which should lead to greater participation and more competitive bids. The DC Commission issued an order on Mar. 1, 2004, that largely adopted the Maryland model as the procurement process for standard offer service after the District's utilities' rate freeze periods end in 2005–06.⁸

The Maryland utilities recently completed their first procurement cycle based on this model using a sealed-bid auction format with four rounds of bidding spread over approximately six weeks. As the PSC announced, the successful and "highly competitive bidding process" involved 25 wholesale suppliers offering four to five times the amount of supply solicited.⁹ (The solicitation involved the complete retail needs of two of Maryland's utilities, PEPCO and Conectiv,

and the non-residential load obligations of Baltimore Gas & Electric as of July 1, 2004. The load subject to procurement in this procurement cycle for these three operating utilities represented about 5,700 MW of peak load, which is about 45 percent of the Maryland total and 7 percent of PJM RTO peak load.) This process resulted in contracts being



awarded to a diverse group of 14 individual suppliers.

- **New Jersey.** The New Jersey utilities recently completed the state's third annual auction for post-transition period "basic generation service."¹⁰ Under the most recent procurement round, which was pre-approved by the Board of Public Utilities, all four New Jersey electric distribution companies simultaneously auctioned off shares of full requirements service for two product classes and two contract durations. Each load share was sized to represent an annual peak load of approximately 100 MW, with contract durations of one and three years. The two products are "Fixed Price" (FP) for residential,

small and medium-size non-residential customers and "Commercial Industrial Electric Pricing" (CIEP) for large non-residential customers with peak loads greater than 1,500 kW. Bids for FP were a fixed, all-in price (cents/kWh) while bids for CIEP included only a capacity charge (\$/MW-day) under which suppliers would provide energy charged at the hourly energy price of the PJM spot market. Under the New Jersey auction process, an Internet-based, multi-round "descending clock" auction format was used to determine a single market clearing price that is applied to all winning bids within each contract type (i.e., utility, customer class, and contract duration). The New Jersey Board found that this procurement process worked well and provided the best prices possible. A New Jersey commissioner also noted other advantages: (1) proper risk sharing (risk is borne by those who can manage it at lowest cost); (2) transparency (leads to more aggressive bidding); and (3) an appearance of objectivity and fairness (attracts more bidders and minimizes post-auction challenges).¹¹

In the most recent auction, a total of 10,000 MW of FP load was auctioned off to a diverse set of 12 winning bidders. These winners were primarily traditional power marketers, but some notable success by Morgan Stanley and J. Aron showed the increasing presence of financial services firms in wholesale energy markets.¹² In addition, a total of

2,460 MW of CIEP load was auctioned off to six winning bidders, all of whom were traditional power marketers. When combined, approximately 12,500 MW, which is 64 percent of NJ's retail load and 15 percent of PJM's, was contracted for during the most recent auction. Another 23 percent of New Jersey's retail load is still being supplied by winners from previous auctions and the remaining 13 percent is being supplied by alternative retail providers.

- **Massachusetts.** Massachusetts has two regulated service offers, "standard offer" for customers that have never switched and "default service" for new customers or customers returning from alternative retail suppliers. The "standard offer service" has been supplied by buy-back contracts from divested generation with the price based on a pre-set schedule and a fuel-price-index adjustment. It expires in February 2005 and all remaining regulated service customers will move to default service. For several years, the procurement of default service supply has been undertaken using a standard-offer approach based on a six-month cycle with overlapping one-year contracts. In an order released in the summer of 2003,¹³ the six-month cycle was shortened to three months (procuring all supplies with quarterly contracts) for medium-sized and large commercial and industrial customers with monthly demands greater than 10 MWh and peak loads in excess of

200 kW. This modification to shorter-term market-based pricing was made to further the development of retail competition for large customers. The Massachusetts Department of Telecommunications and Energy (DTE) found that the overlapping contracts for smaller customers provide protection against spot market volatility, thereby pro-



viding stable market-based prices that customers can compare to other supply options.

- **Maine.** Maine's restructuring law, like that in Massachusetts, required divestiture of all generation and qualifying facility (QF) contract supply; but Maine also dispensed immediately with the price-capped transition period found in other states. Under Maine's retail electric access rules, which opened up retail markets in early 2000, the commission is tasked with ensuring that "standard offer service" is available. The procurement for Maine's standard offer service thus had to precede the start of retail access—at a time when the ISO New England was still in its infancy.

The restructuring laws required that the Commission itself solicit retail suppliers through a competitive bid process in a variation of the standard offer approach. From the beginning, the Maine commission conducted its own "retail" procurement for full-requirements service, experimenting with annual and multi-year contracts.¹⁴ While small customers are served through three-year contracts, in the most recent procurement cycle, bids to supply medium and large customers were solicited for six-month and one-year terms. The commission selected six-month terms to allow regulated retail prices to track more closely changes in market prices in two of its major utility service territories for both medium and large customer classes. Like in many other standard offer states, the Maine commission found that shorter-term pricing for large customers will facilitate service from alternative retail suppliers.

Table 2 also lists six states that utilize variations of the **portfolio management approach**, either alone or in combination with supply provided through utility-owned, rate-regulated generation or through buybacks from unregulated affiliate generation. It is difficult to generalize about the experience with this procurement approach since its applications are so heterogeneous. Arizona and Montana have retail access but only a very small share of retail access load. Montana divested all generation while Arizona mandated the retention

of utility-owned, rate-regulated generation. Nevada and Oregon only allow retail access for large commercial and industrial customers and have not fully divested or restructured generation. Montana and California applied the portfolio management approach only after suspending retail access for most of their customers. Nevertheless, despite this suspension of retail access, California and Montana provide good examples of a comprehensive portfolio management approach.

- **California.** Having sold the vast majority of their natural gas and oil generation plants and being required under restructuring to purchase all requirements through the PX day-ahead market, the California IOUs were devastated by the Energy Crisis of 2000–01, leading Pacific Gas & Electric (PG&E) to file for bankruptcy and Southern California Edison (SCE) to watch its credit rating drop from A to CCC. In early 2001, the California Department of Water Resources (DWR) was forced to step in to purchase spot power and also sign short- and long-term power purchase contracts to supply the retail loads of PG&E and SCE. In September 2002, Bill AB 57 became law, which was designed to put the IOUs back into the resource procurement business, using the portfolio management approach and guidelines that would promote regulatory stability and keep the IOUs credit-worthy. Under this law, the California PUC must review and approve detailed utility procure-

ment plans that clearly define selection criteria for subsequent utility purchases. The resource plans must cover: an assessment of price risk, definitions of resources to be procured, duration of procured products, details of a competitive bid system, inclusion of performance-based rates (if at all), general transaction cost recovery, procedures for



updating the plan, compliance with renewable and demand-side programs, risk management strategy, promotion of supplier diversity, and procurement-related administrative cost recovery. Of these elements, the PUC has pressed utilities for the most detail on risk management strategies, types of products to be procured over particular time-frames, and target quantities for each type of product. The PUC has also promulgated minimum standards, including: use of a competitive, arms-length procurement process; a clear code of conduct for all employees involved in the process; and prudent administration of resources coupled with least-cost

dispatch.¹⁵ Transactions that meet the pre-approved resource plans and procurement processes are automatically approved by the PUC, are presumed to be just and reasonable, and are fully recoverable in rates.

The California experience to date has shown that this process is quite involved. The utilities had to hire significant staff and expend substantial resources to develop portfolio/risk management capabilities. The complexity of this subject area also presents a significant challenge for the PUC and its staff. There is a clear tension between the utilities' need for flexibility in procurement decisions in the face of rapidly changing market conditions or unique procurement opportunities on one hand and the PUC's desire to manage carefully and pre-specify the entire procurement process on the other. Although a "Procurement Review Group" process established by the PUC has been a constructive forum for various stakeholders to discuss key issues, the utilities' major procurement decisions have been fairly contentious. While the PUC has approved 2003 and 2004 short-term plans for the utilities, a full reasonableness proceeding under the new rules has not yet been completed and even the "expeditious" review of quarterly compliance filings has been a somewhat slow and difficult process.

- **Montana.** Montana's initial legislation would have opened all customer classes to retail access

by July 2002. However, in the face of the California energy crisis, retail access for small customers was initially postponed through July 2004. Most recent legislation essentially suspended retail access for small customers until 2027. After Montana Power's divestiture of its generation assets, the expiration of a transitional buyback arrangement with PP&L Montana, and the acquisition of Montana Power by Northwestern Energy, the regulated utility faced the task of assembling a portfolio of resources to meet its regulated service obligation. Regulatory rules and state legislation implemented in 2003 provide "guidelines" under which the regulated utility: (1) should procure the supply for its regulated service customers; (2) can ask the commission to pre-approve specific contracts, thus avoiding the risk of ex-post prudence review. These guidelines specify facts, analyses, and principles the utility should consider but do not mandate specific terms for how the portfolio should be structured.

In response to this regulatory framework, Northwestern Energy recently filed its "Electric Default Supply Service Resource Procurement Plan" with the Montana PSC. The plan contains an extensive comparative risk assessment of 12 different portfolios, each reflecting a different mix of base load, intermediate, and peaking contracts, along with renewable resources and demand-side management options. After ranking these

portfolios based on cost/risk tradeoffs, the filing concludes that the current combination of base load purchase agreements with PP&L (due to expire in 2007) and spot purchases are high-cost/high-risk, and that spot market purchases should be largely replaced with increased reliance on dispatchable gas-fired generation or other firm contracts.



This is the utility's second attempt to obtain the PSC's endorsement of its supply strategy. (Some of the utility's proposed modifications of its supply portfolio were previously filed in 2001, but rejected by the PSC.) After the commission endorses the proposed supply strategy, the utility would assemble the supply portfolio through a series of RFPs and then seek the PSC's approval of the selected contracts in separate filings. Similarly to California, the experience in Montana suggests that obtaining regulatory pre-approval of supply strategies and contracts under the portfolio management approach can be a complex and often contentious undertaking.

Of all the retail access states identified in Table 2, New York and Pennsylvania have perhaps the most difficult-to-categorize procurement approaches. New York has individual settlements for each of its utilities with different timelines and implementation details that are hard to characterize in terms of a statewide procurement policy. In Pennsylvania the utilities' regulated service option is provided at capped rates that were determined for the entire transition period in the initial restructuring effort. Pennsylvania restructuring law does not require utilities to competitively procure generation for these regulated service offerings. Rather, much of the resource requirements for these regulated service options are supplied under buyback contracts from the utilities' unregulated generation affiliates.

VI. Conclusions

The end of restructuring-related "transition periods" marks a critical milestone for regulators and utilities in retail access states as price caps and restructuring-related supply contracts expire. Since the majority of customers, in particular residential and small commercial, remain on the regulated service provided by their distribution utility, there is an implicit "demand" for the continued provision of that service. No state policymakers at this milestone have as yet chosen to



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force small customers to switch to unregulated suppliers.

Continuation of regulated generation service raises two important policy questions: (1) How should regulated retail service be provided after transition-period price caps expire; and (2) How should distribution utilities procure resources to meet their continued regulated service obligations? Of the states that have already addressed these issues, the majority concluded that rates for regulated service should be reasonably reflective of market prices and that resources

for the utilities' continued regulated service obligations should be procured through transparent, competitive processes that are open to all suppliers.

The selected procurement processes have fallen into two general approaches, which we labeled the "standard offer approach" and the "portfolio management approach." The experience to date shows that many of these states have chosen to implement the standard offer approach under which shares of the distribution companies' regulated, full-requirements sup-

ply obligation are bid out. The advantages that policymakers appear to see in this approach are that it is a relatively simple, highly transparent, competitive procurement option that allows for a more streamlined, less contentious regulatory process and that allocates risks to bidders that can manage them most efficiently. Also, while contracts are highly standardized, policymakers can and do offer differing degrees of rate stability to different classes of customers through fixed-priced contracts of varying durations.

The states that have selected some form of portfolio management approach often use it to integrate new wholesale contracts with utilities' existing long-term contracts or remaining cost-of-service regulated generation. The perceived advantages of the portfolio management approach include its roots in integrated resource planning and greater flexibility in the type of wholesale products that can be integrated into the supply portfolio. These include longer-term and unit-specific contracts, and even new utility-owned generation.

Of the 21 states with retail access, we have identified nine that have already addressed post-transition procurement for regulated service through the standard offer model, and six that have pursued variations of the portfolio management approach.■

Endnotes:

1. For simplicity of exposition, the District of Columbia will be included in the "states" in this article.
2. California is included here, with about 13 percent of the total load being competitively supplied, although further retail switching was suspended in September 2001. A new policy that would reintroduce retail access for large customers is now being discussed.
3. These rate reductions were not necessarily inconsistent with market prices since the competitive price of generation service was expected to be low enough so that unregulated suppliers could compete with regulated service rates. However, wholesale market price have been higher than expected, making it

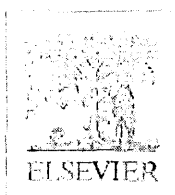
difficult for alternative retail suppliers to provide guaranteed savings while maintaining a level playing field.

4. Note, however, while the more common approach, this kind of a transition was not used by all retail access states. For example, Maine did not include negotiated, capped rates for regulated service, did not sign any buy-back agreements with restructured generation assets, but went directly to procuring resources at market-based rates. In Texas, even in the beginning, large customers were



not offered any regulated service option, only a default service (i.e., provider of last resort service) for periods when service obtained from unregulated retail suppliers was unavailable (e.g., due to supplier default).

5. See Ohio PUC, order dated Dec. 17, 2003, *In the Matter of the Commission's Promulgation of Rules for the Conduct of a Competitive Bidding Process for Electric Distribution Utilities Pursuant to Section 4928.14, Revised Code*, Case No. 01-2164-EL-ORD. Since the PUC issued this order, several Ohio utilities (e.g., DP&L, CG&E, AEP, and First Energy) separately filed alternative proposals that would extend rate caps through 2008.
6. *Auction Could Give Toledo, Ohio-Area Residents Another Utility*, TOLEDO BLADE, Aug. 24, 2004.
7. See MD PSC, Order Nos. 78400 (dated Apr. 29, 2003) and 78710 (dated Sept. 30, 2003), *In the Matter of the Commission's Inquiry into the Competitive Selection of Electric Supplier/Standard Offer Service*, Case No. 8908.
8. See DC PSC, Order Adopting Wholesale Standard Offer Service Process in Case No. 1017, issued Mar. 1, 2004.
9. MD PSC, MD PSC Announces Successful Completion of Bidding for Electric Standard Offer Service (press release), Apr., 2, 2004: <http://www.psc.state.md.us>.
10. See New Jersey Board of Public Utilities, New Jersey Board of Public Utilities Certifies Results of the Basic Generation Service Auction (press release), Feb. 11, 2004. The NJ procurement processes were pre-approved by the Board of Public Utilities: Decisions and Orders in Docket Nos. EX01050303 (dated Dec. 11, 2001), EX01110754 & EO02070384 (dated Dec. 18, 2002), and EO03050394 (dated Dec. 2, 2003).
11. Frederick Butler, Presentation at the Illinois Commerce Commission Post-2006 Symposium, April 29, 2004, at 8.
12. No information has been released about how many tranches of load of various types were awarded to specific winning bidders.
13. Massachusetts D.T.E. Orders 02-40-A, 02-40-B, and 02-40-C, *Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service*, dated Feb. 13, 2003, Apr. 24, 2004 and Sept. 12, 2003.
14. Maine Public Utilities Commission, Standard Offer Study and Recommendations Regarding Service After Mar. 1, 2005, Dec. 1, 2002, Appendix E: Detailed Summary of Standard Offer Bid Processes and Results.
15. California Public Utilities Commission, *Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development*, Decision 02-10-062, Oct. 24, 2002.



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